

BEFORE THE
PUBLIC SERVICE COMMISSION OF WISCONSIN

Investigation on the Commission's Own Motion into the Need for Changes in Natural Gas Regulation for City Gas Company; Florence Municipal Gas Utility; Madison Gas and Electric Company; Midwest Natural Gas, Inc.; Natural Gas, Inc.; Northern States Power Company; St. Croix Valley Natural Gas Company; Superior Water, Light and Power Company; Wisconsin Fuel and Light Company; Wisconsin Gas Company; Wisconsin Natural Gas Company; Wisconsin Power and Light Company; and Wisconsin Public Service Corporation

Docket 05-GI-108
(Phase III)

(Wisconsin Electric Power Company, Gas Operations,
formerly Wisconsin Natural Gas Company)

**FINDINGS OF FACT, CONCLUSIONS OF LAW
AND PHASE III ORDER**

Introduction

This proceeding is an outgrowth of the Commission's investigation into possible reforms of its regulation of natural gas public utilities in Wisconsin to make regulation more consistent with emerging competition for retail sales of natural gas. In March 1992, the Commission formed a utility/staff workgroup to identify and evaluate possible regulatory approaches for the natural gas industry in light of federal changes in pipeline regulation proposed under Order 636 and the Commission's own regulatory goals. The workgroup also examined industry trends and how they might affect state regulatory goals. The culmination of the workgroup was a report entitled, "Workgroup Report on Natural Gas Regulation in Wisconsin." In September 1993, the Commission directed staff to utilize the problem-solving approach to regulation described in that report, but to develop a market-based approach where feasible.

Docket 05-GI-108, Phase III

A Phase I order in 05-GI-108 was issued on December 4, 1995. The Phase I order dealt with the issues of: (1) the manner in which natural gas public utilities may provide service to customers within deregulated market segments under Market Model D¹ (Separate/Allocate Issue); (2) unbundling or refunctionalization of costs underlying segmentable natural gas utility service (Refunctionalization Issue); and (3) contract rates and the use of long-run incremental cost as the standard against which to determine whether negotiated rates for contracted services are compensatory and the associated issue of how long-run incremental costs should be determined (Contract Rate Issues).

In its Phase I order, the Commission also directed that any opportunity sales made by Wisconsin natural gas utilities shall be made pursuant to approved standards of conduct. Standards of Conduct were approved by the Commission in its Phase II order in this docket, issued on January 13, 1997.

The Commission's main issues in Phase III of this docket, 05-GI-108, concern: (1) what standards to apply to determine when a market is sufficiently competitive to be deregulated under Market Model D; (2) whether certification of natural gas marketers may be necessary; (3) what price disclosure requirements may be necessary; and (4) identifying and addressing the barriers to competition in developing natural gas markets in Wisconsin.

Phase III began in September 1995. Written comments were submitted to the Commission in response to two staff questionnaires seeking comments on issues such as standards for measuring competition, barriers to competition and definitions of essential services.

¹ Under Market Model D, the Commission deregulates gas costs for customer classes that have market choices. See, 05-SG-100, Phase II Report, "Approaches to Natural Gas Regulation in Wisconsin" April 25, 1994.

Docket 05-GI-108, Phase III

Joint meetings, involving utility representatives, other gas industry representatives and Commission staff, were later held to discuss barriers to competition. The parties reached general agreement identifying five categories of barriers: (1) interstate pipeline capacity; (2) operational issues; (3) rate issues; (4) public benefit issues; and (5) standards of conduct.

Hearings were held on this phase of the docket in October 1996. Initial and reply briefs were submitted on December 20, 1996, and January 14, 1997, respectively. Parties for purposes of review are included in Appendix A.

On March 13, 1997, the Commission discussed the record in Phase III. This order establishes policy direction, endorses principles, and directs the staff to establish workgroups to address specific issues.

FINDINGS OF FACT

THE COMMISSION FINDS:

The Commission determined that gas restructuring should continue to move forward incrementally and that the current pace is appropriate. The Commission determined it will remove barriers to competition where appropriate and will accommodate competition as it develops.

I. Competitive Market Standards

A. Standards for Effective Competition

Before the Commission can deregulate a natural gas market, in order to protect the public interest, it has to ensure that certain conditions hold in that market. The mere existence of

customer choice in a market is not sufficient to guarantee that the competition in that market is effective. In the economics literature, effective competition is defined to exist when we observe, "...a striving among comparable rivals, who exert a mutual pressure so strong that all competitors must apply maximum efforts. None of them is able to raise price above cost very much, or to remove rivals except by superior efficiency." A market with two well-entrenched competitors who offer similar service at prices well above cost would provide the customer with choice, but it would not likely be an effectively competitive market. Replacing regulation with competition of that nature will not likely benefit consumers. To achieve that end, the market must achieve a higher level of competition.

One of the goals of this investigation is to set standards that will assist the Commission and interested parties in determining when a market is capable of supporting effective competition. There are essentially three schools of thought on this issue in this investigation. The Commission staff and several other parties relied on the principles of workable competition (a form of imperfect competition) to develop a proposed standard. MidCon Gas Services and Wisconsin Electric - Gas Operations based their recommendations on what is known as the contestable market theory. Northern States Power Company suggested that no standard be developed at this time, but rather that the activity in specific markets be analyzed on a case-by-case basis.

Workable Competition Workable competition is the traditional standard which most economists use to analyze the level of competition in markets. It is a comprehensive approach that has been developed based on decades of research and analysis of actual markets. Under this standard, numerous facets of markets are considered: assessments of barriers to entry and exit;

market concentration; the behavior of firms; the ability of consumers to make informed decisions; and the profit levels of the firms in the industry, among other factors.

Staff used the concepts of workable competition to develop a set of standards specific to natural gas utility markets. Under staff's proposed standards, a market is workably competitive if the following criteria are satisfied:

- Reasonable number of firms.
- Low barriers to competition.
- Sufficient available capacity.
- Responsive suppliers.
- Informed customers.

Some parties, such as Madison Gas and Electric, St. Croix Valley Natural Gas, Wisconsin End User Gas Association and Wisconsin Public Service Corporation, supported the basic concepts in staff's workable competition standard, although some of them proposed that additional standards be included.

Wisconsin Gas Company relied on standard economic analysis in proposing a somewhat different list of standards for effective competition. Its list contains the following criteria:

- Low barriers to entry.
- No unilateral exercise of market power.
- Efficient operation of firms.
- Evidence of rivalrous behavior.
- Low to moderate market concentration.
- Responsive suppliers.

Wisconsin Gas also proposed that an empirical test of competition be undertaken prior to deregulation. This test would measure the degree to which prices to end-users followed patterns prescribed by the economic theory of competitive markets.

Although the staff's and Wisconsin Gas's lists are not identical, there is a significant degree of overlap between them. Both describe a market with a reasonable number of competitors who strive to position themselves to meet the needs of customers better than the other firms in the industry. If a market met either of these standards, no firm would be able to take unfair advantage of consumers, and the absence of significant barriers to competition would allow firms to come and go as competitive conditions change.

Contestable Markets MidCon Gas Services and Wisconsin Electric - Gas Operations took a different approach. They suggested that the Commission rely on the contestable markets approach when assessing the level of competition in natural gas markets.

Contestable markets theory is a rather new development in the history of economic thought. This theory suggests that factors considered to be important determinants of competition under the workable competition model discussed above, such as the number of firms in an industry, are in fact irrelevant in assessing whether effective competition exists. One factor alone, under this theory, determines the level of competition in a market—the presence or absence of barriers to entry and exit in that market. If barriers to entry and exit are eliminated, firms would be forced to behave as if they were competing with a large number of firms, for if they did not, with no entry restrictions, other firms would quickly enter the market. This entry would force the original firm to act in a more competitive fashion. According to this approach, the mere threat of competition is sufficient to induce competitive behavior.

Building off of this approach, MidCon Gas Services proposed a barrier removal approach as the standard for determining whether a market exhibits effective competition. It suggests the following analysis:

- Are there competitive barriers inhibiting competition?
- Is there cross-subsidization from regulated markets to deregulated markets?
- Do government incentives encourage uneconomic behavior by regulated entities, such as Local Distribution Company (LDC) retention of pipeline transportation and storage capacity, even after they lose customer load to competitors?
- Are there services remaining to be unbundled?
- Do LDC affiliates receive preferential treatment, including unfair access to confidential LDC marketing information?

If the answer is “no” to these questions for a particular market, then, under this theory, that market could be deregulated regardless of the number of suppliers currently in the market. The advocates of this approach argue that if the Commission removes these barriers, everything else will fall into place and effective competition will occur.

No Standard Northern States Power Company suggested that it is not reasonable to try to develop a generic standard for effective competition. In its opinion, the determination as to whether competition can be effective in a particular market depends much more on the specific circumstances of that market than on economic theory. It, therefore, proposes that the Commission adopt no standard for effective competition.

B. The Approved Competitive Market Standard

The Commission finds that the workable competition approach suggested by staff is the most appropriate standard to be used in assessing whether effective competition exists in a particular market. This standard considers several important dimensions of markets, ranging from the number of suppliers to the knowledge base of the consumers, and is well-founded in the economics literature. Moving from a regulatory monopoly environment to a competitive market requires that conditions other than removal of entry barriers are in place. The Commission was not convinced that a competitive market would develop by simply removing entry and exit barriers. The approved standard consists of: (1) a reasonable number of suppliers (HHI of 2,000-2,500²); (2) low barriers to competition; (3) sufficient available capacity; (4) responsive suppliers; and (5) informed customers. The Commission finds two additional conditions should be added to staff's proposed standard: (6) that the application of the standard be evaluated in the context of the specific facts surrounding the case; and (7) that small gas utilities may be treated differently from large utilities if, on a case-by-case basis, circumstances suggest that a different policy is appropriate.

The Commission finds that the contestable markets approach, while offering insights as to how to better accommodate competition, provides an incomplete standard against which markets are to be evaluated. For example, the contestable markets approach makes no mention of the need to have well-informed customers before competition can be deemed effective. This would be a serious deficiency in a deregulated market and would allow for all competitors to take

² See section I.C., "Measuring Market Concentration," for a description of HHI.

advantage of consumers. As we attempt to move from regulated markets, which contain significant amounts of consumer protection, to deregulated markets where consumer protection is less overt, the need to ensure that consumers are well-armed with information is critical.

The Commission also rejects Northern States Power Company's proposal that no standard be developed in this case. While the Commission recognizes that some specific information might be necessary to conduct a full assessment of the competitiveness of any particular market, that does not mean that there are not any generally applicable overarching principles. The "sufficient available capacity" standard in the workable competition approach demonstrates this point. If there is limited competitor access to capacity in a particular market, then whether that market consists of residential customers in Racine or industrial customers in Superior, the market will not be effectively competitive. The same could be said of the other items contained in the workable competition standard. However, the Commission finds that the approved standards are not the only relevant information that may be used in assessing whether effective competition exists in a market.

C. Measuring Market Concentration

The Commission's approved standard requires that a market contain a "reasonable number of firms" if it is to be considered effectively competitive. Economists have developed a means of quantifying market concentration known as the Hirschman-Herfindahl Index, or HHI. The HHI ranges from near zero when a market is served by many very small competitors to 10,000 when it is served by a single firm. The HHI is calculated by squaring and then adding the percentage market shares of each competitor in the market. For example, if in a particular market

Docket 05-GI-108, Phase III

one firm has 50 percent of total sales, another firm 30 percent, and another firm 20 percent, the HHI for that market would be 3,800 ($50^2 + 30^2 + 20^2 = 2,500 + 900 + 400 = 3,800$). Agencies such as the Federal Energy Regulatory Commission (FERC) and the federal Department of Justice (DOJ) consider a market with an HHI of 1,800 or above to be concentrated. However, both agencies consider the specific circumstances of the case in making a decision on the ability of the market to sustain competition.

Staff proposed that the Commission use a presumptive threshold of 2,000 to determine whether a market is concentrated. Other parties, such as St. Croix Valley Natural Gas, suggested that the more traditional level of 1,800 be used. Wisconsin Electric - Gas Operations suggested that, if the HHI is to be used at all, it be set at a threshold of 2,500, which is the level set by the DOJ for reviewing the use of market-based rates by oil pipelines.

The Commission finds that an HHI range of 2,000 to 2,500 is presumptively appropriate. The Commission finds that this HHI range is a presumptive indicator, not a threshold. An HHI above 2,500 is an indication that a market may be considered concentrated and an HHI below 2,000 is an indication that a market may not be concentrated.

The Commission finds that the HHI is simply a rebuttably presumptive measure of the degree of concentration in a market. While market concentration is an important component of an effectively competitive market, it is not a dispositive measure of effective competition. That is to say, while the Commission would expect in most cases to see an effectively competitive market having an HHI below 2,000; however, it is possible that a market could have an HHI higher than 2,500 and still be found to be effectively competitive. The Commission finds that in such a situation, a showing of intense rivalry among competitors and a showing of significant

product differentiation (e.g., differing reliability choices or alternative billing arrangements) could demonstrate that a concentrated market is effectively competitive. Conversely, a market with an HHI of 1,700 may not be effectively competitive if, for example, suppliers were not responsive to reasonable demands of consumers.

Northern States Power Company suggested that the HHI be calculated without considering the utility's market share. This, according to NSP, would provide a better indication of the potential for competition. Staff suggested that this approach would provide misleading results, especially if the utility has a high market share. For example, if the utility had 90 percent of the market and ten equally-sized competitors served the remaining 10 percent, under NSP's approach the HHI of that market would be 1,000. This suggests a market with low concentration. Under staff's approach, the HHI would be 8,110, indicative of a highly concentrated market.

The Commission finds that the utility's market share should be included in HHI calculations. The utility, as long as it continues to serve a particular market, is part of that market, albeit as a regulated entity. Excluding the utility's share would reduce the value of the HHI as a measure of market concentration.

D. The Relevant Market

Before an assessment of a market's competitiveness can be undertaken, the relevant market must be defined. Staff proposed the following definition for a relevant market:

- The customers purchase the same or similar products and close substitutes are also considered.
- The customers are located in the same geographic area.

- The customers have similar characteristics.

Wisconsin Electric - Gas Operations argued that the third item, similar customer characteristics, was redundant and could be eliminated. Staff disagreed. Northern States Power Company stressed the need to consider close substitutes in the definition of the relevant market, which staff's definition does.

The Commission finds that the definition of a relevant market proposed by staff is reasonable. The definition defines the factors that determine the scope of a market and is similar to that used in modern antitrust analysis.

E. Utility Market Share as an Indicator of Barriers to Competition

Staff suggested that one indicator of possible barriers to competition is the market share of the utility. In an effectively competitive market, the utility should have no inherent cost advantage in providing gas supplies to its customers. Over time, utility market shares should decline as marketers gain customers in utility service territories.

Staff suggested that if a particular utility's market share does not decline, there might be barriers to competition that are preventing marketers from serving that utility's customers. Staff suggested that the Commission might investigate those situations to determine whether barriers exist.

Some parties opposed using utility market shares in this fashion. They suggested that high utility market share may simply reflect the fact that the utility is more efficient than the marketers and, therefore, can offer lower cost service. To these parties, utility market share suggests nothing about the presence of competitive barriers.

The Commission finds that a high utility market share should be a signal to investigate that utility's situation to see if barriers to competition exist. Although a high utility market share does not necessarily mean that there are barriers in place, it is possible that there could be. The Commission finds that it is reasonable to look for barriers in the markets where competitors have not gained significant entry.

If barriers to competition are identified, the Commission must decide what can and should be done about them. Not all barriers to competition can or should be removed. For example, if at least 10,000 customers are necessary for a marketer to achieve scale economies and a particular market has only 3,000 customers, there is little that the Commission can do to remedy that situation. Or, if marketers do not want to enter a particular market because there is a moratorium on winter disconnections, the Commission might decide that particular barrier serves the public interest and should be maintained.

In any event, the Commission finds that it is reasonable to investigate the possibility of competitive barriers when the utility continues to serve a large portion of a market. The Commission also finds that a high utility market share places a greater burden on a petitioner to demonstrate that effective competition exists in a particular market.

F. Deregulation of the Large Volume Interruptible Markets

Some parties suggested that while it is important to develop standards for effective competition before general deregulation of utility markets occur, the large volume interruptible markets are ready to be deregulated now. These parties argue that numerous suppliers currently serve these markets and therefore effective competition can result.

The Commission finds that there is not sufficient evidence on the record to support deregulating this class, or any class of customers, at this point. The Commission finds that certain key questions must be decided before any deregulation occurs. Issues such as marketer certification, consumer education and essential service policy may affect all classes of customers. Simply because competitors stand ready to serve a particular market is not a sufficient reason to deregulate services for that market. As an alternative, the Commission directed staff to study the feasibility of market based utility pricing for large volume interruptible customers.

II. Market-Facilitating Mechanisms

A. Price Disclosure

The staff, Wisconsin Gas and the Wisconsin Community Action Program Association (WISCAP) testified that for competition to be effective, prices charged by marketers should be disclosed or posted in some fashion. Staff argued that this is a critical component of an effectively competitive market. Without price reporting or disclosure requirements, staff argued, it would be difficult to achieve the “well-informed consumers” element of the workable competition standard. Staff and WISCAP argued that there is overwhelming evidence that markets do not supply adequate amounts of information to consumers. Staff cited examples of state and federal laws that require price and information disclosure in industries where suppliers had refused to provide information on their own volition. Wisconsin Gas noted that one of the reasons that the wellhead gas market is so competitive is because of the widespread dissemination of posted prices.

MidCon Gas Services and Wisconsin Electric - Gas Operations suggested that price reporting is unnecessary. They argued that suppliers have the incentive to disclose prices and other relevant information to prospective buyers. They also stated that consumers should seek price information as they do in other markets. MidCon Gas Services suggested that just as consumers may open a telephone book to get quotes for services such as auto insurance, they could do the same when shopping for natural gas. According to these parties, the market would provide reasonable levels of price disclosure and, therefore, no Commission requirement is necessary.

The Commission finds that some form of mandatory price reporting or disclosure by all market participants is necessary for effective competition. The testimony of staff, Wisconsin Gas and WISCAP reveals that markets are not especially strong at providing complete information. Although suppliers do have an incentive to provide information when it is to their advantage, they do not have the incentive to disclose information that is detrimental to their interests. Market failures associated with poor information disclosure are well-documented in the economics literature and has formed the basis for numerous laws in this country, such as Truth-in-Lending legislation and gasoline price disclosure requirements. The Commission finds that price reporting removes a significant barrier to effective competition.

As we move to an era of less rate regulation, the Commission's information and education responsibilities will increase. Perhaps in the future, the flow of information in the market will have developed to the point where price reporting requirements are unnecessary. But today, the Commission finds that price reporting requirements are essential.

This order does not prescribe the exact form that price reporting will take. The Commission directs staff to form a workgroup on price reporting or disclosure. The workgroup may work with interested parties, develop a proposal as to how price reporting can be done efficiently, and should report back to the Commission when the proposal is ready. The Commission finds that the following principles suggested by staff are appropriate guides to be used in developing a price reporting mechanism. These principles require that any price reporting system:

- Provide prices for a reasonable range of natural gas services.
- Provide separate prices for major geographic areas.
- Be sufficiently current to provide useful information to consumers.
- Be publicly available and widely disseminated.

The Commission finds that a reporting system that meets these requirements in an efficient manner should help consumers make better gas purchasing decisions.

B. Marketer Registration or Certification

As part of its investigation in this phase, the Commission received testimony regarding the need to register or certify natural gas marketers. Some parties argued that there are adequate safeguards already in place to protect consumers. They suggested that introducing registration requirements or establishing additional consumer protections could create a barrier to entry, thereby limiting the choices available to customers. Others argued that there is a need to establish certification requirements and that, at a minimum, these requirements should cover issues of creditworthiness and non-performance.

The Commission finds that natural gas marketers should be registered or certified and that registration or certification is necessary to protect consumers. This registration or certification process should not be unduly burdensome so as to create an entry barrier. Providing competitive access to a natural gas market should not result in diminished service for Wisconsin consumers. Competitive markets require customers to make informed choices based on accurate information. The desire to open gas commodity markets up to new competition needs to be tempered with providing customers with some assurance that new market players are able to meet their obligations.

In addition, the Commission finds that the reliability of the Wisconsin natural gas system must be maintained. Actions by a market participant designed to achieve savings or profits should not be permitted if those actions undercut the reliability of the system.

The Commission finds that there is a need to provide protections to consumers in a less-regulated natural gas marketplace. Registration or certification of marketers will help achieve this. The Commission finds that registration or certification may facilitate all of the following:

- Establishing proof of financial responsibility.
- Reporting requirements.
- Dealing with public benefits.
- Provider of last resort issues.
- Assessment of costs.

For all of the above reasons the Commission finds that the registration or certification of marketers is both reasonable and necessary.

The Commission directs staff to form a workgroup to gather the necessary information to recommend appropriate certification or registration provisions. A workgroup will allow interested market participants to provide input into recommended requirements. These recommendations are to be brought back to the Commission, along with proposed drafts of any recommended legislation. The workgroup may also investigate options such as establishing a period of time that new entrants would be required to be certified, a requirement that could later be removed, depending on the development of markets and the need for continued oversight.

The Commission acknowledges that parties questioned what agency should have oversight responsibility for marketers in the future. If the Commission authorizes an unconditional Market Model D abandonment, under which the utility may not serve a market and has no obligation to serve that market, oversight responsibility could potentially reside with an agency other than the Commission. If the Commission authorizes an abandonment with conditions, a model of lesser regulation, oversight responsibility may appropriately remain with the Commission.

III. Essential Services

A. Consumer Protection and Essential Services

The provision of safe, reliable and affordable natural gas services is a business affected with the public interest. Both the capacity to deliver the gas and the supply of gas itself are provided by the utility under its obligation to serve its customers. If gas commodity markets are deregulated, continued regulation of an LDC may not provide assurance that gas supply will be delivered to the utility's distribution system, or to the end-use customer. The Commission finds

Docket 05-GI-108, Phase III

that consumer protection and essential service policy must be addressed before any gas commodity markets are deregulated. In addition, the Commission finds that essential service policies should not be limited to residential customers only and that essential service obligations should apply to all gas suppliers, whether or not they have an obligation to serve.

Although a significant effort was made to establish a complete record on these issues, the record is not sufficient at this point to proceed with policy development without further work from staff and input from parties who may not have been directly involved in this docket. Much of the concern over resolution of these issues revolved around the inaccurate perception that the Public Benefits docket, 05-BU-100, would be the primary forum for consumer protection issues. The Commission finds that this docket was and is a proper forum to develop policy on essential service issues for deregulated natural gas markets. The Commission finds that the Public Benefits docket does not address all aspects of essential service, especially those regarding structural issues in natural gas markets. The Commission finds that these issues need to be addressed before markets are deregulated.

The Commission finds that it is reasonable to convene a workgroup to discuss alternatives and produce recommendations on consumer protection and essential service policy for Commission consideration. The Commission directs staff to form such a workgroup. Because of the critical need to resolve consumer protection policy for essential service customers, this workgroup should begin as soon as possible. Initial policy recommendations should be submitted to the Commission within one year after the workgroup is first convened but no later than August 31, 1998.

The Commission determined that the workgroup should analyze market solutions to meeting the needs of essential service customers. The Commission finds that, to avoid cost shifting to low-income customers, care must be taken to create market conditions where there is competition among suppliers for low-income loads.

The Commission finds that it is reasonable to reestablish or modify current Commission policy on basic consumer protections before any gas or electric commodity markets are deregulated.

The Commission finds that the following definition of essential services is reasonable:

“Essential services are those services which, if not delivered, or if disconnected, would endanger the health, safety, and welfare of customers who cannot afford to pay for these services, or to be without these services for any reason.”

The Commission finds that demand-side management services are a partial substitute for natural gas and should be considered an essential service for low-income customers. This is consistent with the essential services definition and the Commission’s definition of relevant markets.

B. Principles of Service

The Commission endorses, to the extent applicable, the following Public Benefits principles developed in the electric industry restructuring docket 05-EI-114 with the understanding that these are overarching principles and that there may be conflicts between them:

- Public Benefits will be preserved.
- Conservation programs will continue.
- Renewable resources will be encouraged.

- The winter moratorium on disconnection will continue.
- The commitment to gas and electric low-income programs and universal electric service will be permanent.
- All customers should benefit or should have the opportunity to benefit from energy utility restructuring.
- Affordable, safe, reliable, and cost-effective energy services should be available for all Wisconsin consumers.
- All consumers and energy providers should share in the costs of providing low-income energy services.

The Commission noted that there are differences between the electric and natural gas industries that may be relevant and that universal service in the context of the natural gas industry does not mean statewide availability.

IV. PSC Abandonment Authority

A. Current Authority

In the course of this proceeding, some parties asked whether the Commission has the statutory authority to order an LDC to abandon a market if that market is found to be sufficiently competitive. Consequently, a portion of this docket was dedicated to addressing this legal issue.

Staff addressed the question directly by indicating that the Commission had sufficient statutory authority. Staff noted that existing s. 196.81, Stats., authorizes “abandonment with conditions” as well as unconditional abandonment. Staff posited that an abandonment process

could be initiated by an LDC, the Commission or by others and indicated that abandonment decisions would be made on a case-by-case basis.

Wisconsin Public Service Corporation argued that the Commission lacked authority to force an LDC to abandon a market. Wisconsin Gas Company suggested that abandonment with conditions should not be used unless the conditions for re-regulation were made explicit. Northern States Power Company supported statutory revisions to describe the level of regulation in a competitive market, similar to the language in s. 196.195(3), Stats.

The Commission finds that it has existing statutory authority to order an abandonment unconditionally or an abandonment with conditions under current s. 196.81, Stats. That abandonment statute expressly states that “the commission may impose any term, condition or requirement it deems necessary to protect the public interest.” Sec. 196.81(1), Stats. The Commission also found that it had the authority to act in this area because it is authorized “to supervise and regulate every public utility in this state and to do all things necessary and convenient to its jurisdiction” under s. 196.02(1), Stats.

The Commission takes official notice that it has in the past ordered abandonments under its statutory authorization. In docket 05-TA-100, the telephone customer premises or inside wiring case, the Commission authorized abandonment under s. 196.81, Stats., and its authority to do so was not challenged.

The Commission finds that, in addition to a public utility, the Commission may initiate an abandonment proceeding on its own motion under s. 196.81, Stats., and another person may also initiate a request for abandonment.

The Commission finds that the question of abandonment authority is an interpretation of law rather than a policy decision.

B. Statutory Review

The Commission directed staff to form a legislative workgroup to review existing law and to recommend to the Commission possible legislative or administrative rule changes necessary to accommodate the move to a competitive market. The Commission is not giving staff specific direction at this time regarding what, if any, legislative changes should be pursued. The Commission identified several natural gas restructuring topics for this workgroup to consider. The workgroup should determine if there is any issue of federal preemption, whether statutory authority is needed to facilitate marketer registration or certification, and to facilitate price reporting. In addition, the workgroup should consider changes in the context of consumer protection, public benefits and essential service, and the impact any change may have on other areas of Commission jurisdiction.

V. Barriers to Competition: Principles

A. Primary Barriers

A consensus document was drafted by several parties to this proceeding regarding the barriers that exist to the development of competition in the natural gas industry in Wisconsin. The Commission agrees, in general, with the document. These principles will help guide the future discussion and resolution of barrier-related issues that come before the Commission.

The Commission finds that the most significant barriers to the development of competition in Wisconsin natural gas markets are the lack of pipeline capacity, the means to retain existing capacity to continue to serve Wisconsin markets, and the resolution of how low-income and essential service customers will be protected during the shift from a regulated industry to a competitive, market-based industry. The Commission finds that it is critical to address these issues before moving forward with deregulation and abandonment.

Wisconsin does not have a large number of gas pipeline alternatives. The pipelines serving this state continue to use pure straight-fixed-variable pricing, which gives a substantial economic incentive to Wisconsin LDCs to de-contract as much capacity as they can, consistent with their remaining responsibilities. Much of this state is served by only one pipeline. Much of western Wisconsin is capacity-constrained. A process of divestiture of LDC capacity, similar to the FERC's Order 636 process, would increase a pipeline customer's ability to divert already scarce capacity supplies from Wisconsin. As the demand for natural gas continues to increase in markets to the east of Wisconsin, an economic incentive to shift Wisconsin capacity to serve those markets may also develop. This would hamper the ability of Wisconsin utilities' natural gas customers and marketers to secure capacity on a basis comparable to that enjoyed by states with more competitive choices. The Commission finds that the lack of capacity options, and the ability to retain capacity, are barriers to the development of competition. Developing an agency policy regarding capacity should be a priority for the Natural Gas Division. This policy should also address the minimization of transition or stranded costs and the impacts on customers remaining with the LDCs. The Commission directs staff to form a workgroup to review these issues, including transition costs, and to develop policy options for addressing these concerns.

The Commission is open to pilot proposals for exploring alternatives. It is not necessary that pilot proposals wait for the workgroup to complete its task prior to implementation.

The third significant barrier is addressing the needs of low-income and essential service consumers. Wherever appropriate and in the public interest, the Commission's preference is to permit this state's gas supply needs to be met by market-based services. Low-income and essential service customers in many instances may not be able to access these market-based services without assistance or intervention. However, this does not mean that this assistance must be carried out by government entities. Staff is directed to explore market-based methods of delivering these services. Low-income and essential service customers, like all residential customers, should be protected from unfair market practices and failure to deliver safe and reliable services.

The Commission finds that the lack of consumer education is a barrier to competition. The Commission finds that there is a need to address the educational needs of all customer classes during this transition period because the Commission recognizes that markets cannot be effectively competitive if customers are not well-informed.

B. Principles

The Commission finds the following general principles to be reasonable. It is appropriate to consider these principles in future natural gas proceedings.

Transition The natural gas industry in Wisconsin is entering a new phase. Customer selection of a natural gas merchant from among many competitors will be encouraged. Customer selection of a gas merchant is expected to reach successively smaller-volume customers as

barriers to competition are removed and as economics dictate. The time period over which this change will take place is not certain.

Obligation to Serve LDCs will retain the obligation to offer gas merchant service until a particular market is determined to have workable competition by the Commission. At that time the Commission will determine whether the LDC will be permitted to offer merchant service to customers in that market segment and whether the LDC will have a continuing obligation to serve that segment. The Commission will also determine whether a provider of last resort is necessary for that market.

Consumer Protection Basic consumer protection safeguards are necessary and consumers must also have access to information before gas merchants offer service. The consumer protection safeguards should be generally uniform and reviewed periodically as customer segments become better educated. All customer classes need to be educated.

All customers should have the opportunity to realize the benefits of deregulation. No customer class should be harmed or competitively disadvantaged as a result of barrier removal. When addressing barrier removal, the Commission will consider the effect on LDC shareholders. LDC shareholders should not be competitively disadvantaged as a result of the removal of barriers to customer selection of a gas merchant.

Supplier Access The role of the Commission regarding the entrance of new gas merchants into new markets during and after the transition to a competitive market must be clearly defined.

Capacity Retention All parties recognize the need to retain sufficient interstate pipeline capacity and storage capacity to serve all current and future Wisconsin gas market segments

during the transition to a workably competitive market. If pipeline and storage capacity are transferred from Wisconsin LDCs to natural gas merchants, there should be provisions for transferring the capacity back to the LDC if the Commission determines that the capacity is not being appropriately utilized to serve the full requirements of customers in this state.

Long-Term Capacity Planning There are significant unresolved issues regarding the long-term provision of pipeline and supply capacity and its impact on existing customers, new customers and LDCs.

Transition Costs Minimization of transition costs shall be a prime consideration in the transformation of natural gas markets in Wisconsin.

Telemetry Efforts should be made to replace the current requirement to telemetry small volume transportation customers with other methods, such as demand algorithms. Testing is needed to evaluate the accuracy of these methods prior to large scale implementation.

Small LDCs Small LDCs may face economic issues associated with accommodating a competitive marketplace. If appropriate for a small LDC, exceptions or modifications to these principles may be made.

Monitoring The results of efforts to create competitive market segments will be evaluated periodically by the Commission.

VI. Barriers to Competition: Remedies

In keeping with the Commission's policy of accommodating competition, staff identified several existing barriers to competition. Some of these barriers have already been considered and addressed in recent rate cases for some utilities. Others have not been addressed for any utility thus far. The Commission finds that the consideration of barrier removal in individual rate cases

is reasonable because it allows consideration of the specifics of each utility's situation.

However, in some situations, it may be a more logical and efficient process to employ a generic proceeding to consider removal strategies for specific barriers. In this docket, the Commission finds that for the following barriers, the associated remedies are appropriate unless substantial evidence is presented in an individual rate case which would warrant modification.

Transportation Administration Fees The Commission notes that many transportation administration fees were initially set at approximately \$150 per month in anticipation of increased costs for serving what were then new customers. As a result, transportation service may have been unduly restricted to the largest volume customers. The Commission finds that high transportation administration fees have operated as a barrier to competition. The cost basis of these fees should be reexamined in light of experience, and the fees lowered if cost-justified.

Cost-Based Services The Commission finds that fees for services should be cost-based to eliminate barriers. Unwarranted cost shifts to residential customers are to be avoided. The term "cost-based" is not limited to traditional embedded costs; the Commission may consider market-based cost proposals in individual cases, such as incremental or marginal cost.

True Pooling Requiring a utility to receive individual nominations from pool participants defeats one of the primary purposes of aggregation. The Commission finds that groups, or pools, of transportation customers have been denied the full benefits of aggregating their loads by the requirement to balance account-by-account. True pooling, or balancing on a pool-wide basis, has been implemented in several recent utility rate cases. The Commission finds that the absence of

true pooling has operated as a barrier to competition and that true pooling should be implemented in future rate cases, absent compelling evidence to the contrary.

The Commission finds that under true pooling, only the pooling agent, and not each individual customer in a pool, should be assessed penalties. The Commission finds that in this narrow instance the pooling agent should be considered to be a customer, within the meaning and scope of the administrative code.

Incumbency It was alleged that a customer's familiarity with an LDC, as opposed to a new marketing entrant, would give rise to a partiality toward the LDC and that this advantage to the incumbent LDC would constitute a barrier to competition. The Commission finds that LDC incumbency can be a barrier to competition and should be monitored. The staff is directed to consider, in the course of its usual investigations in future individual cases, whether incumbency provides an LDC with an unfair advantage over new market entrants.

Billing Components Some utilities continue to bill for utility service on a largely bundled basis. Including gas costs in the basic charge for service obscures competitive choices for those customer classes who presently have them. As barriers are removed and more customer classes have choices, this problem will increase. The Commission finds that bundled billing operates as a barrier to competition. Requiring utilities to have itemized charges on their bills will help speed the progress toward competitive markets by identifying the charges that are distribution or facility related and those that are supply or commodity related. Having a clear separation lets

customers know that the natural monopoly utility service is in the distribution function, not the supply function, and may encourage customers to seek out more competitive supply options.

A related problem exists where certain gas costs are still included in the development of the distribution margin rate component. Transporters should not be required to pay costs that are related to the utility's acquisition of gas supplies, such as carrying costs on gas supplies or the cost of supply personnel. The Commission finds that in future individual rate cases, all pure gas supply costs should be removed from the distribution margin and placed into a separate gas supply charge.

Seasonal Recovery of Demand Costs Some utilities continue to collect pipeline peak demand charges from utility sales customers on a uniform basis throughout the year. These charges are caused by peak winter loads, rather than by usage during the summer. Therefore, collecting these costs in the winter season better matches the cost-causer with the cost-payer. The Commission finds that seasonal collection of pipeline demand charges minimizes distortion of price signals, which might be used to gain an unfair competitive advantage. The Commission finds that seasonal recovery of demand costs should be implemented in future individual rate cases.

Interruptible Loads Interruptible customers have not been allocated any pipeline peak demand cost based on the ratemaking theory that these customers will not be taking service during peak demand times. The Commission notes that many interruptible customers are taking service, on-peak, year after year, without paying the true cost of on-peak service. On utility systems where interruptible service is tantamount to firm service, there is a price distortion and subsidization

which may result in a barrier to competition. The Commission finds that interruptible loads should be proportional to the operational needs of the utility and priced accordingly. The optimum amount of interruptible load and pricing is that which maximizes the class revenue contribution to the revenue requirement without affecting system reliability, without changing the capacity requirement of the LDC system, and without increasing costs to firm customers. Interruptible sales service is not to be used as a marketing tool to retain customers if such sales are not needed for optimal system operation.

VII. Transition Costs and Pilot Programs

A. Transition Costs

Wisconsin Power and Light Company offered testimony regarding transition costs and which customers should be responsible for paying them. Staff argued that, although this is an important issue that must be resolved prior to deregulation, it was not identified as an issue in this proceeding, and the record is insufficient to make a decision. The Commission finds that transition costs associated with the move from regulated to deregulated markets should be minimized, but the methodology for determining which markets or customer classes should bear the burden for specific transition costs was not an issue in this proceeding. The Commission directs staff to address the issue of transition costs in a workgroup. The Commission generally supports a cost-causer, cost-payer concept, as well as protection for low-income customers on this issue.

B. Capacity Pilot Programs

Wisconsin Gas Company offered testimony urging the Commission to order utilities to design and implement capacity pilot programs to address issues of transferring capacity from the LDC to customers, in the transition to deregulation. Staff and several parties opposed the proposal, and argued that workgroups would be more productive. The Commission rejects Wisconsin Gas Company's mandatory pilot proposal, but finds that properly-designed pilot programs may be allowed on a case-by-case basis. Such pilots are not likely to provide much insight on the economic aspects of deregulation, but may provide useful information on some operational aspects of deregulation. The Commission directed staff to address issues surrounding capacity in a workgroup.

VIII. Miscellaneous

A. Application of Principles

The Commission endorses a number of principles in this phase of the docket. These principles reflect the fact that the Commission has not yet determined the specific desired end-state for the natural gas industry. The Commission finds that the principles described in sections III.B. and V.B. of the Findings of Fact, to the extent appropriate, shall be applied by staff and natural gas utilities in all appropriate natural gas proceedings.

B. Administrative

Unless otherwise specified, all compliance filings and all requests for interpretations, waivers or exceptions should be directed to the Administrator of the Natural Gas Division.

C. Environmental

This is a Type III action under s. PSC 4.10(3), Wis. Adm. Code. Because no unusual circumstances have come to the attention of the Commission which indicate that significant environmental consequences are likely, neither an environmental impact statement under s. 1.11, Stats., nor an environmental assessment is required.

D. Effective Date of Order

Under s. 196.40, Stats., an order or determination of the Commission shall take effect 20 days after the order or determination has been filed and served on the parties to the proceeding unless the Commission specifies a different effective date in the order or determination. The Commission finds it is reasonable that this order be effective one day after the date of mailing.

FINDINGS OF ULTIMATE FACT

THE COMMISSION FINDS:

1. An incremental approach to natural gas deregulation is reasonable. Where appropriate, the Commission will work to remove barriers and to accommodate competition.
2. An effectively competitive market will have a reasonable number of firms, low barriers to competition, sufficient available capacity, responsive suppliers and informed customers. Standards will be applied on a case-by-case basis and small gas utilities may be treated differently, if appropriate.
3. Market concentration should be measured with the HHI. The HHI calculation should include the LDC's market share. A market with an HHI below 2,000 is presumed to be not concentrated, while a market with an HHI above 2,500 is presumed to be concentrated. These presumptions are rebuttable.

4. The level of market concentration alone is not dispositive as to whether a market is or is not effectively competitive.

5. A relevant market for purposes of deregulation would include customers who purchase the same product, who have access to the same substitutes, who are located in the same geographic region and who have similar characteristics.

6. A high utility market share suggests that barriers to competition may exist.

7. There is not sufficient evidence on the record to conclude that the large volume interruptible market is ready to be deregulated.

8. For competition to be effective, prices charged by all market participants will have to be disclosed and publicly available.

9. Registration or certification of natural gas marketers is necessary.

10. Consumer protection and essential service policy issues need to be addressed before any gas markets are deregulated.

11. The definition of “essential services” in the Findings of Fact is reasonable.

12. The principles of service described in Section III.B. of the Findings of Fact should be considered, to the extent applicable, by natural gas utilities in future natural gas proceedings.

13. The Commission has existing statutory authority to authorize abandonment unconditionally or abandonment with conditions if it determines that a market is sufficiently competitive for natural gas supply.

14. It is important to educate utility customers regarding changes in the natural gas industry. Educational programs are necessary for customers in all service classes.

15. The principles for removing barriers described in Section V.B. of the Findings of Fact should be considered, to the extent applicable, by natural gas utilities in future natural gas proceedings.

16. The following remedies, described more fully in Section VI. of the Findings of Fact, are reasonable and are to be applied in future individual rate cases:

a. High transportation administration fees have operated as a barrier to competition and the cost basis of these charges is to be re-examined and the fees lowered if cost-justified.

b. Fees for services are to be cost-based to eliminate barriers and to avoid unwarranted cost shifts to residential customers.

c. The requirement for individual nominations and penalties for pool participants has operated as a barrier to competition by denying the benefits of aggregation. These barriers should be eliminated by implementation of true pooling provisions, absent compelling evidence to the contrary.

d. Incumbency may be a barrier to competition and should be investigated to ensure that it does not confer unfair competitive advantages upon the LDC.

e. Bundled pricing acts as a barrier to competition. Gas supply costs should be removed from the distribution charge and shown on customers' bills as a separate charge.

f. Uniform, year-round recovery of peak pipeline demand costs distorts prices and operates as a barrier to competition. Seasonal collection of these costs best matches the cost-causers with the cost-payers and should be implemented.

g. Distorted pricing of interruptible sales operates as a subsidy and a barrier to competition. Interruptible sales loads should be proportional to the operational needs of a utility system and priced accordingly.

17. Properly-designed pilot programs may be allowed on a case-by-case basis, but should not be mandatory.

CONCLUSION OF LAW

THE COMMISSION CONCLUDES:

That the Commission has jurisdiction under ss. 196.02, 196.03, 196.20, 196.37, 196.395 and 196.81, Stats., to enter an order establishing rates, terms and conditions for the provision of natural gas utility services in this state and to establish terms and conditions under which Wisconsin natural gas public utilities may provide service to competitive markets and that the terms and conditions prescribed in this Findings of Fact, Conclusion of Law and Order are just, reasonable and necessary, and are in the public interest.

ORDER

THE COMMISSION ORDERS:

1. Natural gas utilities shall consider the principles of service described in Section III.B. of the Findings of Fact in future natural gas proceedings.

2. Natural gas utilities shall consider the barrier removal principles described in Section V.B. of the Findings of Fact in future natural gas proceedings.

Docket 05-GI-108, Phase III

3. Natural gas utilities shall consider the remedies described in Section VI. of the Findings of Fact and in the Ultimate Findings of Fact 16. in future rate cases.

4. For purposes of assessing penalties, natural gas utilities shall consider pooling agents to be customers under the Wisconsin Administrative Code.

5. The order shall be effective the day after mailing.

6. Jurisdiction is retained.

Dated at Madison, Wisconsin, _____

By the Commission:

Lynda L. Dorr
Secretary to the Commission

LLD:jl:mad:\order\05-GI-108 final order 6-3-97

See attached Notice of Appeal Rights

Notice of Appeal Rights

Notice is hereby given that a person aggrieved by the foregoing decision has the right to file a petition for judicial review as provided in s. 227.53, Stats. The petition must be filed within 30 days after the date of mailing of this decision. That date is shown on the first page. If there is no date on the first page, the date of mailing is shown immediately above the signature line. The Public Service Commission of Wisconsin must be named as respondent in the petition for judicial review.

Notice is further given that, if the foregoing decision is an order following a proceeding which is a contested case as defined in s. 227.01(3), Stats., a person aggrieved by the order has the further right to file one petition for rehearing as provided in s. 227.49, Stats. The petition must be filed within 20 days of the date of mailing of this decision.

If this decision is an order after rehearing, a person aggrieved who wishes to appeal must seek judicial review rather than rehearing. A second petition for rehearing is not an option.

This general notice is for the purpose of ensuring compliance with s. 227.48(2), Stats., and does not constitute a conclusion or admission that any particular party or person is necessarily aggrieved or that any particular decision or order is final or judicially reviewable.

4/22/91